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Reuben A. Hasson

*Osgoode Hall Law School of York University*

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## GOOD FAITH IN CONTRACT LAW — SOME LESSONS FROM INSURANCE LAW

Reuben A. Hasson\*

In the last few years there has been a flurry of writing in Canada on whether there is a need for a doctrine of "good faith" in contract law.<sup>1</sup>

One commentator has stated that the requirement of "good faith" is already part of Canadian contract law<sup>2</sup> although the same author later says, somewhat inconsistently, that "the doctrinal development is less than a judicial half-step away".<sup>3</sup> The generally accepted view, however, is that of the Ontario Law Reform Commission which in its *Report on Sale of Goods* stated that "It cannot be said that good faith is already an integral part of our sales law".<sup>4</sup>

Once we turn to definitions of what good faith is, we find phrases that are deliciously vague, such as, "fair conduct",<sup>5</sup> "ethical ideas of fair dealing",<sup>6</sup> "decent behaviour"<sup>7</sup> and "community standards of fairness, decency and reasonableness".<sup>8</sup>

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\* Professor of Law, Osgoode Hall Law School, York University. I am indebted to my colleagues Professors Harry Glasbeek and David Vaver for reading the article and making valuable suggestions.

<sup>1</sup> See Trebilcock, *Good Faith in Sales Transactions*, Research Paper No. II. 3, Ontario Law Reform Commission, Sale of Goods Project; Ontario Law Reform Commission, *Report on the Sale of Goods* (1979), Vol. 1, pp. 163 *et seq.*; Reiter, "Good Faith in Contracts", 17 Valparaiso U.L. Rev. 705 (1983); Girard, "'Good Faith' in Contract Performance: Principle or Placebo?", 5 Sup. Ct. L. Rev. 309 (1983); Bridge, "Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?", 9 C.B.L.J. 385 (1984); Belobaba, "Good Faith in Canadian Contract Law" and Grover, "A Solicitor Looks at Good Faith in Commercial Transactions". Both the last two contributions appear in Law Society of Upper Canada Special Lectures, Commercial Law (Toronto, Richard DeBoo, 1985), pp. 73 and 93 respectively.

<sup>2</sup> See Belobaba, *supra*, footnote 1, at p. 73, where the author writes: "I argue that good faith and fair dealing are already a *de facto* doctrine".

<sup>3</sup> *Ibid.*, at p. 77.

<sup>4</sup> See, *supra*, footnote 1, at p. 163. See also Bridge, *supra*, footnote 1.

<sup>5</sup> See Holmes, "A Contextual Study of Commercial Good Faith: Good Faith Disclosure in Contract Formation", 39 U. Pitt. L. Rev. 381 (1978), at p. 442.

<sup>6</sup> Fried, *Contract as Promise* (Cambridge, Harv. U. Press, 1981), p. 83.

<sup>7</sup> Ontario Law Reform Commission, *Report on the Sale of Goods*, *supra*, footnote 1, at p. 163.

<sup>8</sup> See Thigpen, "Good Faith Performance under Percentage Leases", 51 Miss. L.J. 315 (1981), at p. 321.

The purpose of this article is to show that "good faith" has had a long history in the law of insurance which the Canadian advocates of a requirement of "good faith" have ignored and which, if considered, might have given them pause.

I will try to show in this article, that "good faith" has radically different meanings in English, Canadian and U.S. law. The courts in the U.S. have seen "decent behaviour" and "community standards of fairness and decency" in an entirely different light from the way that courts in England and Canada have seen these standards. Moreover, the results generated from "good faith" as applied in all these jurisdictions range from the unsatisfactory to the grotesque. The brocard frequently is a proxy for some pet policy the court thinks should be advanced.

I will then argue that the judges be given detailed guidance as to what constitutes "decent behaviour" rather than that they try to give meaning to such amorphous phrases according to their own individual perceptions. The moral for general contract law will be obvious.

### Good Faith in English Insurance Law<sup>9</sup>

In England good faith is *uberrima fides* — utmost good faith. The starting point is Lord Mansfield's opinion in *Carter v. Boehm*.<sup>10</sup> The statement by Lord Mansfield that has been cited to the exclusion of everything else in that opinion is the following:<sup>11</sup>

The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only; the under-writer trusts to his representation, and proceeds upon confidence that he does not keep back any circumstances within his knowledge, to mislead the under-writer into a belief that the circumstance does not exist, and to induce him to estimate the risque, as if it did not exist.

That statement has been read as requiring a very wide duty of disclosure on the part of the insured. Two points need to be made here. In the first place, both in *Carter v. Boehm* and in every

<sup>9</sup> Here I have drawn substantially from two of my earlier articles; see "The Doctrine of 'Uberrima Fides' in Insurance Law — A Critical Evaluation," 32 M.L.R. 615 (1969); and "The Special Nature of the Insurance Contract: A Comparison of the American and English Law of Insurance", 47 M.L.R. 505 (1984), at pp. 508-10.

<sup>10</sup> (1766), 3 Burr. 1905, 97 E.R. 1162 (K.B.).

<sup>11</sup> *Ibid.*, at p. 1909.

insurance case Lord Mansfield decided, he found for the *insured*. Thus, in *Noble v. Kennoway*,<sup>12</sup> he held that the underwriter was under a duty to inform himself with respect to the practice of the trade that he insured. Then, in *Court v. Martineau*,<sup>13</sup> Lord Mansfield held that the insurer had waived the need to have information from the insured by accepting a very large premium for the risk.

Secondly, in *Carter v. Boehm*,<sup>14</sup> Lord Mansfield stated that the doctrine of good faith was "applicable to all contracts and dealings".<sup>15</sup> The fact that Lord Mansfield thought that his principle applied to all contracts suggests very strongly that he favoured a very narrow duty of disclosure. A broad duty of disclosure is simply inconsistent with a capitalist law of contract.

In the 20th century,<sup>16</sup> the English courts have disregarded both what Mansfield said and did and they have imposed a very broad duty of disclosure on the insured. The results of this course of action have generally been seen in recent years to be disastrous to the insured.

### Uberrima Fides in Operation

It is possible within the confines of this article to select only some of the unfortunate decisions that good faith has produced.

In *Horne v. Poland*,<sup>17</sup> the insured was an alien who had been born in Rumania and had come to England at the age of 12. Twenty-two years later he took out an insurance policy against burglary. When he claimed in respect of an alleged loss, the insurer pleaded that the insured had failed to disclose the place of his alien birth and this failure to disclose a material fact voided the policy. Lush J. upheld the defence and found for the insurer.

Probably, the decision in *Horne v. Poland* represented sound "community morality" to the insurers;<sup>18</sup> it also may well have

<sup>12</sup> (1780), 2 Doug. 510, 99 E.R. 326 (K.B.).

<sup>13</sup> (1782), 3 Doug. 161, 99 E.R. 591 (K.B.).

<sup>14</sup> See, *supra*, footnote 10.

<sup>15</sup> *Ibid.*, at p. 1910.

<sup>16</sup> I date the modern English law from the decision of the English Court of Appeal in *Joel v. Law Union and Crown Insurance*, [1908] 2 K.B. 863 (C.A.), affg [1908] 2 K.B. 431. There are two 19th century decisions which recognize a broad duty of disclosure on the part of the insured but these decisions are aberrant; see *Bates v. Hewitt* (1867), 2 Q.B. 595; and *London Ass'ce v. Mansel* (1879), 11 Ch. D. 363 (C.A.).

<sup>17</sup> [1922] 2 K.B. 364. The decision in *Horne v. Poland* has now been reversed by the Race Relations Act 1976 (U.K.), c. 74; see ss. 3 and 20.

<sup>18</sup> English insurers were still practising discrimination against members of at least one

represented sound "community morality" to most of the English judiciary in 1922. Equally certainly, it would not have been seen as an example of "decent behaviour" or good "community morality" among the insuring public. For one thing, the insuring public would be quite unaware that the law required them to disclose material facts on their own initiative. After all, they were (and are) not required to disclose such information about themselves when applying for employment,<sup>19</sup> for a lease or for credit.

Next, the Court of Appeal held, in *Locker and Woolf, Ltd. v. Western Australian Insurance Co. Ltd.*,<sup>20</sup> that an insured must report a rejection for motor vehicle insurance when he applied for fire insurance. This decision is remarkable because even an insured who knows about the duty of disclosure would be astonished to discover that it had such a broad scope. As the Law Reform Committee *Report on Conditions and Exceptions in Insurance Policies*<sup>21</sup> pointed out in 1957, "a fact may be material to insurers . . . which would not necessarily appear to a proposer for insurance, however, honest and careful, to be one which he ought to disclose."<sup>22</sup>

Then there have been cases where the insurer has been able to avoid liability because of the insured's criminal convictions which had not been disclosed. Thus, in *Schoolman v. Hall*,<sup>23</sup> the insured suffered a burglary loss which the insurer admitted to be genuine. Despite the fact that the insured's record related to a "dim and remote past"<sup>24</sup> — the most recent of the insured's convictions had taken place 15 years before the taking out of the policy — the court upheld the insurer's defence.

In *Regina Fur v. Bossom*,<sup>25</sup> Pearson J. accepted as material a

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racial group as late as 1966; see W.W. Daniel, *Racial Discrimination in England* (Penguin Special, 1966), pp. 200-3. Daniel demonstrated that a West Indian applicant who was carefully matched as regards relevant criteria such as motoring history and occupation with a white Englishman and an immigrant of Hungarian origin, suffered discrimination at the hands of 17 to 20 insurers, as compared with his two co-applicants. On six occasions cover was refused altogether, and on 11 other occasions the West Indian applicant was quoted a higher premium than was demanded of the other two applicants. How far the situation has changed in the last 20 years is anyone's guess.

<sup>19</sup> But see now the remarkable decision in *Courtright v. Canadian Pacific Ltd.* (1983), 5 D.L.R. (4th) 488, 45 O.R. (2d) 52, 26 B.L.R. 17 (H.C.J.), affd 18 D.L.R. (4th) 639n, 50 O.R. (2d) 560n (C.A.).

<sup>20</sup> [1936] 1 K.B. 408 (C.A.).

<sup>21</sup> Cmnd. 62, 1957.

<sup>22</sup> *Ibid.*, at p. 4, para. 4.

<sup>23</sup> [1951] 1 Lloyd's Rep. 139 (C.A.).

<sup>24</sup> *Ibid.*, at p. 143.

<sup>25</sup> [1957] 2 Lloyd's Rep. 466, affd [1958] 2 Lloyd's Rep. 425.

single conviction for receiving stolen property in 1933, more than 20 years before taking out the policy. Similarly, in *Woolcott v. Sun Alliance and London Insurance*,<sup>26</sup> the plaintiff applied for fire insurance on his house through the building society to which he was making at the same time a mortgage application. He failed to disclose the fact that he had been convicted of robbery some 12 years earlier.

Some of these results might be decided differently since the passing of the Rehabilitation of Offenders Act 1974,—<sup>27</sup> which seeks to erase criminal convictions after a certain period of time. The Act lays down a complicated tariff. Thus, a conviction resulting in a sentence of two and one-half years' imprisonment or more can never be erased. Otherwise, convictions with custodial sentences of between six months and two and one-half years become spent after 10 years and those of less than six months after seven years. In respect of other sentences, the period is five years, except in relation to absolute discharges (six months) and probation (one year).<sup>28</sup>

To complicate matters further, s. 7(3) of the Act gives the court a discretion to admit evidence as to spent convictions if the court is satisfied that "justice cannot be done in the case except by admitting it."

I have dealt with this statute in some detail because it demonstrates the difficulties and the need to counter the disastrous results that a principle of "good faith" was producing.<sup>29</sup>

The Rehabilitation of Offenders Act 1974 deals only with the conviction of the insured; it does not deal, for example, with the criminal record of a spouse or family member. Thus, in *Lambert v. Co-operative Insurance Society Ltd.*,<sup>30</sup> a wife had insured her property, which was stolen.<sup>31</sup> Her claim was rejected, with regret,

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<sup>26</sup> [1978] 1 W.L.R. 493 (Q.B.).

<sup>27</sup> (U.K.), c. 53.

<sup>28</sup> *Ibid.*, s. 4(3)(a).

<sup>29</sup> In one case, in which the facts arose before the passage of the Rehabilitation of Offenders Act, the judge was able to hold that evidence of a previous conviction was an immaterial fact; see *Reynolds v. Phoenix Ass'ce Co. Ltd.*, [1978] 2 Lloyd's Rep. 22 (C.A.).

<sup>30</sup> [1975] 2 Lloyd's Rep. 485; the decision is trenchantly criticized by Merkin, 39 M.L.R. 478 (1976).

<sup>31</sup> A small portion of the property insured belonged to the husband but nothing seems to have turned on this fact.

by the court because she had failed to disclose that her husband had a criminal record!<sup>32</sup>

Before I deal with proposed reforms in the United Kingdom, it is worth noting that while the cases state that the insurer owes duties of disclosure to the insured,<sup>33</sup> there is only one case which has applied this principle. That was the decision of Pain J. in *Horry v. Tate & Lyle Refineries Ltd.*<sup>34</sup> In this case, the insurer settled a personal injury claim for £1,000. Pain J. held that: (i) the insurer was obliged to point out that the sum offered was on the low side; (ii) that they should have supplied the victim with a copy of the medical report supplied by his (the plaintiff's doctor); (iii) they should have made sure the plaintiff understood that if he accepted the money, that would be an end of the matter; and (iv) the plaintiff should have had an opportunity of testing himself back at work and a proper opportunity of thinking over the offer.

The effect of the decision is highly problematic. For one thing, the decision may be weakened or nullified by an appellate court. Second, it is extremely uncertain how many accident victims and lawyers will know of the decision.<sup>35</sup>

For the rest, the insurer does not have to disclose anything. Thus, insurers do not have to notify a beneficiary of a life insurance policy taken out by the insured, without the beneficiary's knowledge, after the insured's death.<sup>36</sup> Insurers are also under no duty to disclose the rate of return on the investments made to their policyholders.<sup>37</sup> Finally, an insurer will not have to disclose that it has serious financial problems<sup>38</sup> or that it has unskilled staff or incompetent actuaries.

<sup>32</sup> It remains an open question whether the courts will apply the principle in *Lambert* to other members of the household.

<sup>33</sup> See, e.g., the dicta in *Carter v. Boehm* (1766), 3 Burr. 1905 at p. 1910, 97 E.R. 1162 (K.B.); *Re Bradley and Essex and Suffolk Accident Indemnity Society*, [1912] 1 K.B. 415 (C.A.), at p. 430.

<sup>34</sup> [1982] 2 Lloyd's Rep. 416. It is remarkable that such an important decision should be buried in the comparative obscurity of Lloyd's Reports.

<sup>35</sup> Other limitations on the scope of the decision are pointed out by Merkin in his note, "Personal Injury Compensation: Slightly Sugaring the Pill", 46 M.L.R. 99 (1983).

<sup>36</sup> See the excellent note, "Insurer's Duty to Disclose the Existence of a Policy", 76 Colum. L. Rev. 825 (1976). This note discusses American authorities, but English and Canadian law follow the same rule.

<sup>37</sup> The question of price disclosure does not seem to be discussed at all in the United Kingdom.

<sup>38</sup> Between 1946 and 1971 more than 20 automobile insurers collapsed. At no time did anyone raise the question of the insurer's duty to disclose their parlous financial state. If this seems an unrealistic duty to impose, it must be remembered that this is no more an unrealistic duty than those currently imposed on the insured.

Eventually, the Law Commission was forced into examining the duty of disclosure. In its report issued in 1980 the commission<sup>39</sup> recommended the retention of a duty of disclosure. This was so because such a duty was recognized "by the laws of all the common law . . . jurisdictions which we have been able to study".<sup>40</sup> Apart from the fact that this is not a reason which should carry any force, it is simply not true. In Canada, the duty of disclosure has been severely restricted in the fields of fire, life and disability insurance.<sup>41</sup> The duty of disclosure has been restricted even more severely in the United States which, as to 49 states and federal jurisdiction, is surely a common law country.<sup>42</sup>

At the same time the commission thought the law was "defective"<sup>43</sup> but it opposed both the abolition of the duty of disclosure or a "special attenuated duty"<sup>44</sup> for the insured. Instead, the insured is to be under an obligation to disclose facts which a reasonable *person* rather than a reasonable *insurer* would think material.<sup>45</sup> This is the same solution as was recommended by the Law Reform Committee in 1957.<sup>46</sup>

Apart from the fact that no attempt is made to give any content to the insurer's duty of disclosure, there are a number of serious difficulties with the commission's proposals. In the first place, it seems to be assumed that the average consumer applicant knows that there is a duty of disclosure at all. It is likely, in my view, that most people, without a legal training, have no knowledge of any duty of disclosure. Professor Atiyah, in a comment addressed to the Law Commission after their working paper had appeared,<sup>47</sup> suggested that the commission try to find out how many people without a legal training knew about the duty of disclosure. Sadly, the commission did not do this.

If applicants for insurance have no knowledge of the duty of

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<sup>39</sup> Cmnd. 8064, 1980.

<sup>40</sup> *Ibid.*, at p. 42.

<sup>41</sup> See *infra*, text at footnotes 51 to 79.

<sup>42</sup> See *infra*, text at footnotes 96 to 106.

<sup>43</sup> See Report, *supra*, footnote 39, at p. 107.

<sup>44</sup> *Ibid.*, at pp. 46-7.

<sup>45</sup> *Ibid.*, at p. 49, para. 51.

<sup>46</sup> Cmnd. 62, 1957, para. 14.

<sup>47</sup> Atiyah, *Comments on Law Commission Working Paper No. 73 of Insurance Law*, p. 6, para. 7.



disclosure but they are required to disclose what a reasonable applicant would have disclosed, then we have a truly Gilbertian situation. Theoretically, a judge could say that since the applicant has no knowledge of the duty of disclosure she is not obliged to disclose anything, but this is unlikely to occur. Judges will assume, as the Law Commission did, that applicants for insurance know about the duty of disclosure. Many (perhaps most) judges will assume that applicants are as familiar with the duty of disclosure as they (the judges) are.

To this must be added the crucial factor of the proof of materiality. In a Scottish case, *Zurich General Accident and Liability Insurance Co. v. Leven*,<sup>48</sup> Lord Robertson observed: "I recognise that in a case of this kind it may be difficult for litigants in the position of defenders to procure suitable opinion evidence."<sup>49</sup> This difficulty in obtaining expert evidence on what is "material" will be with insureds even after the proposed change in the law. It is true that the experts will not be giving expert evidence as to what would influence a prudent insurer as material, but rather evidence of what a prudent insured would think material. However, the line here is going to be very fine and, in some cases, invisible.

In short, no one has been able plausibly to defend the British doctrine of *uberimma fides*, at least since the end of World War II. On the other hand, the number of critics who are in favour of its abolition is growing.<sup>50</sup> If the doctrine survives, it will not be because it has anything to do with "fairness", "decent human behaviour" or "community morality". It will survive because of the enormous political power that insurance companies enjoy.

### **Good Faith in Canadian Insurance Law**

The insured's duty of disclosure is narrower in Canada than it is in England. This is because the duty has been virtually abolished in fire insurance,<sup>51</sup> and it has been severely curtailed in life and disability insurance.

<sup>48</sup> [1940] S.C. 407.

<sup>49</sup> *Ibid.*, at p. 411.

<sup>50</sup> See Hasson, *supra*, footnote 9; Merkin, *supra*, footnote 30; Atiyah, *supra*, footnote 47; Collins, *The Law of Contract* (London, Weidenfeld & Nicolson, 1986), p. 94; Birds, "The Reform of Insurance Law", J. Bus. L. 449 (1982), at pp. 450-4.

<sup>51</sup> See statutory condition 1, s. 125 of the Ontario Insurance Act, R.S.O. 1980, c. 218. The other provinces have identical provisions.

## Fire Insurance

In fire insurance the insured's duty of disclosure is violated only if there has been a fraudulent withholding of information.<sup>52</sup> The Supreme Court of Canada held, in *Taylor v. London Ass'ce Corp.*,<sup>53</sup> that fraud here meant common law fraud and not "equitable" fraud. Now, it is difficult enough to prove fraud when the contracting party makes a representation;<sup>54</sup> it is virtually impossible to prove fraud when the contracting party says nothing at all. It is, therefore, perhaps not surprising that I have not been able to find a case since 1935 where an insurer has been able to prove fraudulent non-disclosure.<sup>55</sup>

The special rule relating to fire insurance can produce bizarre results. Suppose a homeowner takes out a multi-peril policy with company *A* in 1982. This policy covers him against loss by fire and theft. In 1983, he suffers loss through fire and theft in respect of which he is reimbursed. In 1984, he changes his coverage to company *B* because of *B*'s lower rates. He does not disclose his previous losses. In 1985, he suffers losses again through fire and theft. In this case, the insurer will almost certainly have to pay in respect of the fire loss, since it is most unlikely that the insurer will be able to prove that he was guilty of "fraudulent non-disclosure". However, the insurer will have little difficulty in resisting the claim for theft since here it only has to prove that the insured failed to disclose a material fact to the insurer. The insured's only hope is that the court will treat the multi-peril policy as essentially a fire insurance policy<sup>56</sup> and apply the rule in *Taylor v. London Ass'ce Corp.*<sup>57</sup> But even if the court did this, we still have the

<sup>52</sup> The position was unclear until the decision of the Supreme Court of Canada in the *Taylor* case (see *infra*, footnote 53).

<sup>53</sup> [1935] S.C.R. 422, [1935] 3 D.L.R. 129.

<sup>54</sup> See, e.g., *G.K.N. Centrax Gears Ltd. v. Matbro*, [1976] 2 Lloyd's Rep. 555 (C.A.), where there was the clearest evidence of fraud but no allegation of fraud was made by the plaintiff!

<sup>55</sup> *Goldshlager v. Royal Insurance Co. Ltd.* (1977), 84 D.L.R. (3d) 355, 19 O.R. (2d) 166 is sometimes cited as an example of fraudulent non-disclosure but I regard it as a case of simple misrepresentation. The insured's agent was asked how many mortgages there were on her house; he said "three" when in fact there were seven. The judge dealt with the case on the basis of non-disclosure but there was no need to do this.

<sup>56</sup> This question was first brought to the attention of the Association of Superintendents in 1939. The issue remains unresolved right up to the present day; see Baer, "Recent Developments in Canadian Law: Insurance Law", 17 *Ottawa L. Rev.* 631 (1985), at pp. 636-9.

<sup>57</sup> See, *supra*, footnote 53.

anomalous rule of one rule of disclosure for fire insurance and another for theft, liability, crop and other insurances.<sup>58</sup>

The reason why there is a special rule for fire insurance has nothing, of course, to do with "community standards of morality" and the like. The explanation for the special rule in fire insurance has to do with the fact that fire insurance was the first insurance contract to be regulated in Canada<sup>59</sup> and, since the insurance industry in Canada at that time was relatively weak, it was possible to insert a number of provisions which give more protection to the insured than exists in other insurance contracts. The rule requiring the insured's disclosure to be "fraudulent" is one such rule. Another special fire insurance rule is the power that was given to the courts to strike out an "exclusion, stipulation, condition or warranty . . . if it is held to be unjust or unreasonable by the court".<sup>60</sup>

### Life Insurance

The insured's duty of disclosure is limited in life insurance by the existence of the "incontestable" clause. The role of the "incontestable" clause is to prevent insurers from raising the defences of misrepresentation and non-disclosure after the policy has been in force for two years, unless the insurer can prove fraud.<sup>61</sup> The incontestability clause was devised in the United States as a device to help sell life insurance.<sup>62</sup> In some states, the policy is incontestable after one year.<sup>63</sup> Furthermore, in the United States, the policy is incontestable after the one or two-year period (depending on the relevant state law) even if the insurer can prove fraud.<sup>64</sup>

In Canada, given the difficulty of proving "fraudulent non-dis-

<sup>58</sup> This anomaly has troubled at least one other commentator; see Comment by Heighington, 34 Can. Bar Rev. 93 (1956).

<sup>59</sup> The constitutionality of this regulation was upheld in *Citizens Insurance Co. of Canada v. Parsons* (1881), 7 App. Cas. 96 (P.C.).

<sup>60</sup> See s. 128 of the Ontario Insurance Act. An identical provision appears in other provincial legislation. This provision was applied for the first time in *Krupich v. Safeco Insurance Co. of America* (1985), 63 A.R. 30, 16 C.C.L.I. 18 (Q.B.).

<sup>61</sup> See, e.g., Holland, "The Incontestable Clause" in Krueger and Waggoner, eds., *The Life Insurance Policy Contract* (Boston, Little, Brown & Co., 1953), p. 57; W.F. Young Jr., " 'Incontestable' — as to What?", [1964] U. Ill. L. F. 323.

<sup>62</sup> See Holland, *ibid.*

<sup>63</sup> See Belth, *Life Insurance: A Consumer's Handbook* (Bloomington, Indiana University Press, 1973), p. 124.

<sup>64</sup> *Ibid.*

closure", there appears to be only one reported case in which the insurer was able to prove this. In *Berthiaume v. Great West Life Ass'ce Co.*,<sup>65</sup> the Quebec Court of Appeal decided by a 3-2 majority that the insured had been guilty of fraudulent non-disclosure.

If the policy has not been in force for two years, then the ordinary law of disclosure can be used in a manner that is reminiscent of the English case law. This is illustrated by the grotesque decision of the Supreme Court of Canada in *Henwood v. Prudential Insurance Co.*<sup>66</sup> In this case, Ms Henwood took out a life insurance policy when she was 19 years old. In it she named her mother as the beneficiary. Fourteen months later she was killed in a car accident.

After leaving school at the age of 16, Ms Henwood, a practising and devout Roman Catholic, fell in love with a young man whose faith was that of a Jehovah's Witness. Considerable pressure was brought on Ms Henwood to break off the relationship, which she did. However, after doing so, the insured developed a certain amount of stomach distress and insomnia. Her family doctor described Ms Henwood as a

"... normal average, teen-age girl at that age when they usually start to have some problems, discussions at home, arguments with parents, or especially father due to some disagreement about dates and things like that, but nothing unusual."<sup>67</sup>

Her mother then insisted on Ms Henwood seeing a psychiatrist. Ms Henwood, in fact, saw two psychiatrists<sup>68</sup> but neither seemed to think that she was ill or needed extended treatment.

In September, 1962, Ms Henwood's mother went into hospital for a serious operation. From that date until February, 1963, when her mother was unable to do the household chores, the insured did all the housework. This included getting up at 6:30 a.m. and making breakfast for her stepfather, her brothers and two boarders. She did all the cooking, laundry and paid all the household bills. In February, 1963, she accepted a job as a

<sup>65</sup> (1945), 12 I.L.R. 84.

<sup>66</sup> (1967), 64 D.L.R. (2d) 715, [1967] S.C.R. 720.

<sup>67</sup> See the dissenting judgment of Mr. Justice Spence, *ibid.*, at p. 724 D.L.R., p. 730 S.C.R.

<sup>68</sup> She saw a Dr. Blake on three occasions but stopped seeing him because she could not afford his fees. She also saw a Dr. Murray in the outpatient's clinic at St. Michael's hospital from April, 1962, to June 28, 1962; see the dissenting judgment of Mr. Justice Spence, *ibid.*, at pp. 724-5 D.L.R., pp. 730-1 S.C.R.

bookkeeper, where she worked until her death in a car accident 15 months later.

Prudential Insurance called its doctor, Dr. Roadhouse, who was not a psychiatrist but who none the less gave evidence to the effect that Ms Henwood was suffering from "severe neurosis"<sup>69</sup> and would not have been considered an acceptable risk.

Mr. Justice Ritchie, writing for the majority (Spence J. dissenting), upheld Prudential's claim. The majority concluded that, although Dr. Roadhouse was testifying only about what the Prudential would have done, there is no evidence to suggest that "this was unreasonable or that other insurance companies would have followed a different course." This approach makes a mockery of the "prudent insurer" test which had been unquestioned law since 1924,<sup>71</sup> and which is supposed to give the insured a little protection.

The second disturbing feature of the case is how the majority came to regard Dr. Roadhouse as an expert in psychiatry when he repeatedly professed ignorance in that field.<sup>72</sup>

Finally, it is disturbing that the court should have overlooked the evidence of the doctors who examined Ms Henwood and who found her normal.

As a precedent, *Henwood* could hardly be less satisfactory. One must take comfort from the fact that in the most recent case on disclosure in life insurance, the courts have taken a more liberal position on far weaker facts than those in the *Henwood* case.<sup>73</sup>

### Disability Insurance

There are incontestability provisions in the case of disability insurance (accident and sickness insurance) similar to the one

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<sup>69</sup> See the dissenting judgment of Mr. Justice Spence, *ibid.*, at p. 726 D.L.R., p. 736 S.C.R.

<sup>71</sup> See *Mutual Life Insurance Co. of N.Y. v. Ontario Metal Products Co.*, [1925] 1 D.L.R. 583, [1925] A.C. 344 (P.C.).

<sup>72</sup> See the dissenting judgment of Mr. Justice Spence, *supra*, footnote 66, at p. 730 D.L.R., p. 736 S.C.R.

<sup>73</sup> See *Hudson v. Mutual of Omaha Insurance Co.* (1974), 51 D.L.R. (3d) 115, [1975] I.L.R. 1-660 (B.C.S.C.), *affd* 74 D.L.R. (3d) 321, [1977] I.L.R. 1-855 (B.C.A.). In this case, the courts held that the insured need not disclose evidence of severe depression since this did not constitute mental illness. The force of the decision is undermined considerably by the fact that the insurer already had information relating to Mr. Hudson's depression.

existing in life insurance<sup>74</sup> but there appears to be no litigation in this area. One reason for this may be that disability insurance is sold to a very narrow section of the population.<sup>75</sup>

### Policy Renewals

*Uberrima fides* becomes important on the renewal of a policy. This is illustrated by the decision of the Supreme Court of Canada in *Turgeon v. Fortin*.<sup>76</sup> In that case, the insured had obtained an auto liability policy on August 7, 1959. The insured was asked before issuance of the policy if he had ever had his licence suspended or revoked. To this question, he answered truthfully that he had not. The insured renewed his policy on August 7, 1960 and again on August 7, 1961.

However, on July 31, 1961, the insured pleaded guilty to a charge of driving while under the influence of alcohol contrary to s. 223 of the Criminal Code, and his licence was suspended for three months. In October, 1961, the insured was involved in an accident as a result of his negligence. The insurer disclaimed liability because the insured had failed to disclose his disqualification from driving in July, 1961. The Supreme Court held, by a majority of 3-2,<sup>77</sup> that the insured had been guilty of non-disclosure and the insurer was not liable.

To be sure, the case would have been decided on the basis of misrepresentation<sup>78</sup> but there are serious objections to applying principles of non-disclosure or misrepresentation to a renewal situation. To allow the insurer to prove, say, five years later that an insured's answer was incorrect is not fair. For one thing, the insured may have forgotten what answer he gave in the proposal form. Second, even if he can remember the answer, he may believe that the change in circumstances is immaterial. It would be no great burden for insurers to get insureds to check the answers given in the original proposal form.

In fire insurance, when the insured renews this doctrine can

<sup>74</sup> See s. 262 of the Ontario Insurance Act.

<sup>75</sup> See *Report of the Select Committee on Company Law, The Insurance Industry Fifth Report on Accident and Sickness Insurance* (1981), p. 151.

<sup>76</sup> (1968), 13 D.L.R. (3d) 308, [1969] S.C.R. 286, *sub nom. Turgeon v. Atlas Ass'ce Co. Ltd.*.

<sup>77</sup> Mr. Justice Fauteux gave the judgment of the majority for himself and Justices Martland and Judson; Mr. Justice Pigeon gave a dissenting opinion for himself and Mr. Justice Hall.

<sup>78</sup> See, e.g., *Re Wilson & Scottish Ins. Corp. Ltd.*, [1920] 2 Ch. 28.

undermine the protection given to the insured by requiring the insurer to prove that the insured withheld information "fraudulently".<sup>79</sup> Consider the following example. A took out fire insurance for his business in 1980. In reply to the question, "Estimate your turnover during the past year", the insured answered truthfully: \$100,000. A renewed his policy in 1981, 1982, 1983 and 1984. In 1985, his business premises were destroyed by fire. By 1985, his turnover had dropped to \$50,000. The insurer would not seek to rely on "fraudulent non-disclosure", since that is virtually impossible to prove. Instead, it would rely on misrepresentation of a material fact. The insurer would argue, with great chance of success, that the insured's drop in turnover constituted a "moral hazard". Thus, a protection given by the Insurance Act in respect of "fraudulent non-disclosures" would be nullified.

### **The Insurer's Duty of Disclosure**

One might expect the insurer to owe at least some kind of duty of disclosure to the insured. Unfortunately, this is not the case.

In *Pense v. The Northern Life Ass'ce Co.*,<sup>80</sup> the insured had the right to a paid up policy or extended insurance if his policy lapsed because of non-payment of premium. The insured had to signify which of the two benefits he wished to claim. The insured did not claim these options before the policy lapsed, probably because he did not know what they meant.<sup>81</sup> In any event, it was not argued that the insurer owed a duty to disclose to the insured that it could claim either of these benefits. To this day, there is no duty on an insurer after the insured has surrendered the policy to explain the insured's options under the policy.

There is some doubt as to whether Canadian courts are even willing to accept an insurer's duty to co-operate. In *Kropelyn v. Federated Life Insurance Co.*,<sup>82</sup> the insured had made an overpayment of a premium by mistake under a life policy. The insured did not make a payment within the grace period and the policy lapsed. The beneficiary argued that the insurer was obliged

<sup>79</sup> See text at, *supra*, footnote 51.

<sup>80</sup> (1907), 15 O.L.R. 131 (C.A.), *affd* 42 S.C.R. 246.

<sup>81</sup> I have found in my experience as an insurance law teacher that students do not know what these terms mean. I would expect laymen to have no better idea of what these terms mean.

<sup>82</sup> (1984), 8 D.L.R. (4th) 311, [1984] I.L.R. 1-1803 (B.C.S.C.).

to apply the overpayment so as to prevent the lapse of the policy. American authorities were cited including one from a leading insurance text which stated:<sup>83</sup>

The general rule is that where an insurer has in its hands funds absolutely belonging to the insured, sufficient to prevent a forfeiture, it must apply those funds to the payment of premiums in order to prevent a default from terminating the policy protection.

Finch J. rejected this contention because in the American authorities the insurer had either actual or constructive knowledge that it was indebted to the insured. This distinction is manifestly unsatisfactory. At some point, the insurer had knowledge that it was in possession of funds belonging to the insured.

The lesson of the *Kropelyn* case is that before we go chasing after concepts such as "good faith", we need to learn to apply well-established concepts such as "the duty to co-operate".<sup>84</sup>

### Good Faith and the Insurer's Duty to Defend a Liability Claim

There is a small group of cases in which Canadian courts have started using "good faith" in liability claims.

Thus, in the Ontario case of *Pelky v. Hudson Bay Insurance Co.; McKittrick, Erickson, Jones (Third Party)*,<sup>85</sup> the insured, Fortes, was covered under an automobile policy issued by Royal Insurance with a \$50,000 limit. The common law spouse of the insured, Pelky, was involved in an accident, and one passenger was rendered a quadriplegic and another passenger was hospitalized for five months. The passengers sued Pelky and Fortes. Prior to trial, counsel for the plaintiffs submitted an offer to settle within the policy limits. Royal's solicitor did not communicate the offer to Royal and proceeded to trial where judgment was awarded in the plaintiff's favour in the amount of \$137,060.43 and \$12,000 respectively.

Pelky and Fortes, being unable to satisfy the judgment, began an action against Royal and its solicitor for \$50,000. Mr. Justice Catzman held Royal liable but did so on the basis of modern American authorities.

<sup>83</sup> See Appleman, *Insurance Law and Practice* (1944), vol. 15, p. 49, at s. 8271, quoted at (1984), 6 C.C.L.I. 19 at p. 24.

<sup>84</sup> See Burrows, "Contractual Co-Operation and the Implied Term", 31 M.L.R. 390 (1968).

<sup>85</sup> (1981), 35 O.R. (2d) 97, [1982] I.L.R. 1-1493 (H.C.J.).



The learned judge wrote:<sup>86</sup>

"... in every contract, including policies of insurance, there is an implied covenant of good faith and fair dealing that neither party will do anything that will injure the right of the other to receive the benefits of the agreement... that the implied obligation of good faith and fair dealing requires the insurer to settle in an appropriate case although the express terms of the policy do not impose the duty; that in determining whether to settle the insurer must give the interests of the insured at least as much consideration as it gives its own interests; and that when 'there is a great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of the insured's interest requires the insurer to settle the claim.'

... the test is whether a prudent insurer without policy limits would have accepted the settlement offer."

There is at least one other case in which an Ontario judge used "good faith" to resolve the insurer's duty to defend liability claims.<sup>87</sup> However, as Warren Grover points out, there is no need to use concepts of "good" and "bad" faith here. It is enough to say that the insurer was in breach of its contract to use reasonable care.<sup>88</sup>

Seventy-five years ago Mr. Justice Holmes, when dealing with an identical problem, also saw no need to resort to concepts such as "good faith". In *St. Louis Dressed Beef and Provision Co. v. Maryland Casualty Co.*,<sup>89</sup> the defendant insurer issued a policy insuring the plaintiff for one year against liability for injuries caused by vehicles or the horses of the insured. The policy provided that if a suit were brought against the plaintiff to enforce a claim, the insurer would defend or settle the proceeding (up to \$5,000 for any one injured person).

In 1901, the plaintiff's employee negligently injured Mrs. Nellie Heideman. Mrs. Heideman sued for \$10,000 and her husband sued for \$3,000. The insured notified the insurer of the accident but the latter took no action. Eventually, the plaintiff settled both claims for \$2,500. It now sought to recover this sum, together with attorney's fees, from its insurer.

The insurer argued that the insured should have defended the

<sup>86</sup> *Ibid.*, at p. 115 O.R., pp. 5707-8 I.L.R.

<sup>87</sup> *Dillon v. Guardian Insurance Co.*, [1983] 2 C.C.L.I. 227, [1983] I.L.R. 1-1706 (Ont. H.C.J.).

<sup>88</sup> See Grover, *supra*, footnote 1, at p. 106.

<sup>89</sup> 201 U.S. 173 (1906).

suit against it. Mr. Justice Holmes, writing for a unanimous U.S. Supreme Court, rejected this contention. Holmes J. wrote:<sup>90</sup>

Contracts rarely provide in detail for their non-performance. It would be stretching the words quoted to a significance equally hurtful to both parties, and probably equally absent from the minds of both, to read them as having within their scope an initial repudiation of liability by the defendant, and a requirement that, in that event, the plaintiff should be bound to try the case against itself, although it should be plain that by a compromise it could reduce its claim on the defendant as well as its own loss.

For Holmes J., the insurer's failure to defend was a simple breach-of-contract case. There was no need to talk about "good faith" and other phantoms.

The approach taken in *St. Louis Dressed Beef*<sup>91</sup> has also been taken in some Canadian cases. Thus, in *Shore Boat Builders v. Canadian Indemnity Co.*,<sup>92</sup> the insured, a boat builder, insured against liability in respect of defective boats built by him. The insurer assumed any "liability imposed by law". The insured built a boat for the customer but the boat was built defectively and the customer suffered damages to the extent of \$7,279.91.

The insured paid the customer this sum but the insurer refused to indemnify the insured because the phrase "liability imposed by law" meant that there had to be a formal judgment against the insured. Hutcheon J. rejected this contention; in his view the insured was entitled to be reimbursed if he made a reasonable settlement. The requirement of a formal judgment would only add to the expense of the insured's recovery. Again, no mention was made of any duty of "good faith".

Then, in *McDonough v. Fire Insurance Co. of Canada*,<sup>93</sup> the insured had taken out an automobile policy with her insurer. When the insured was involved in an accident, her insurer refused to defend her. In the event, the insured was held not liable and the action against her was dismissed. However, she received no costs and her solicitor's costs were taxed at \$2,000. When she sought to recover this sum from her insurer, the insurer argued that it had a right to withdraw from the insured's defence because the insured had breached a policy provision. Wren Co. Ct. J. held that the insurer's correct course of action in this situation was to seek to be joined as a third party from which position it could

<sup>90</sup> *Ibid.*, at p. 183.

<sup>91</sup> See, *supra*, footnote 89.

<sup>92</sup> (1974), 51 D.L.R. (3d) 628, [1975] 1 L.R. 1-674 (B.C.S.C.).

<sup>93</sup> (1974), 56 D.L.R. (3d) 671, 8 O.R. (2d) 29 (Co. Ct.).

seek to deny liability. Again, quite sensibly, the judge does not seek to traverse the swamps of "good faith".

Although the doctrine of good faith is more limited in Canada than it is in England, it causes hardships for the insured. Among academic commentators, only Professor Rendall seems to think that there is a marginal role for the doctrine.<sup>94</sup>

Further, the duty of disclosure is one-sided. The insurer does not seem to be under any duty to disclose anything.

Finally, the courts are beginning to use the concept of "good faith" to impose a duty on the insurer to defend the insured. I have argued that this duty is totally unnecessary; its only function seems to be to make opinions longer than they are at present.

In short, it would be a desirable development if "good faith" could be removed from Canadian insurance law. Once it was removed, it would be possible to deal with some of the real problems in that body of law.

### **Good Faith in U.S. Insurance Law**

The insured's duty of disclosure has been reduced to what Harnett rightly calls a "remnant" in the law.<sup>95</sup> The major decision in this area is that of Judge Taft — later President and, later still, Chief Justice of the United States — in *Penn Mutual Life Insurance Co. v. Mechanics Savings Bank and Trust Co.*<sup>96</sup> In this very influential judgment, Judge Taft held that an applicant for insurance need not disclose "self-disgracing facts".<sup>97</sup>

Later, courts began to insist that the insurer show that the insured's non-disclosure was fraudulent. Thus, in *Roberto v. Hartford Fire Insurance*,<sup>98</sup> the insured was an alien who had been imprisoned for perjury and was liable to deportation for this offence. The Court of Appeals for the Seventh Circuit held that in the absence of inquiry, the insurer had to show that the insured had fraudulently concealed this information. Requiring the insurer to show that information has been fraudulently concealed is virtually impossible, particularly in the presence of a jury.

<sup>94</sup> See his comment, "The Disclosure Duty in Fire Insurance: Herein of Insincere Applicants, of Apathetic Agents and of Unwise Judicial Expiation", 12 *Man. L.J.* 393 (1982), at p. 396.

<sup>95</sup> See his article, "The Doctrine of Concealment: A Remnant in the Law of Insurance", 15 *L. and Contemp. Problems* 391 (1950).

<sup>96</sup> 72 Fed. 413 (C.C.A. 6th, 1896).

<sup>97</sup> *Ibid.*, at p. 435.

<sup>98</sup> 177 F.2d 811 (7th Cir., 1949).

In the case of life insurance, once the policy has been in force for one year (in some states, two years), the insurer will not be able to avoid the policy even if it can prove a fraudulent disclosure.<sup>99</sup>

In one area the U.S. courts have not required that the insurer prove that the insured withheld information fraudulently. This is in the rare situation where there is a change in the insured's health or a change in other circumstances between the time the insured fills in the proposal form and the acceptance of the risk by the company.

Two cases will illustrate how this duty operates. In *Stipcich v. Metropolitan Life Insurance Co.*,<sup>100</sup> the insured applied for life insurance and filled in a proposal form. At the time Stipcich filled in the proposal form, he was in good health. Shortly after filling it in, however, he was told by a physician that he needed an operation to remove an ulcer. Mr. Justice Stone, giving the opinion of the U.S. Supreme Court, held that a different rule applied in the "change of circumstances" situation. According to the court "the most elementary spirit of fair dealing would seem to require him to make a full disclosure."<sup>101</sup>

Fortunately, Mr. Stipcich had informed his agent of the medical condition so that Stipcich's beneficiary was allowed to recover.

*Stipcich* was followed in *Mackenzie v. Prudential Insurance Co.*<sup>102</sup> Mackenzie applied for life insurance and his medical examination revealed that he was in good health and his blood pressure was found to be 140/78 (within normal limits). A short while later, Mackenzie suffered a chest bruise. When he visited his doctor, it was found that his blood pressure had risen to 170/100 (higher than normal). Mackenzie was given a diuretic to decrease his blood pressure and he was advised to get a medical check-up. Mackenzie did not disclose this information to the insurer. On Mackenzie's death, the insurer successfully resisted a claim by Mackenzie's beneficiary, because Mackenzie had not disclosed his subsequent accident to the insurer.

These cases are most unfortunate. It is perfectly reasonable for

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<sup>99</sup> See Belth, *supra*, note 63.

<sup>100</sup> 277 U.S. 311 (1928).

<sup>101</sup> *Ibid.*, at p. 317.

<sup>102</sup> 411 F. 2d 781 (6th Cir. 1969).

applicants for insurance to assume that they will be accepted or rejected based on the information they have provided in the proposal form.

The rule in cases such as *Stipcich* and *McKenzie* is to some extent neutralized by the insurer's duty to process a life insurance application promptly.<sup>103</sup> In one case, an insurer was held not to have processed an application promptly because it did not do so within 48 hours!<sup>104</sup>

### **The Insurer's Duty of Disclosure**

The insurer's duty of disclosure in the United States is extremely attenuated. Thus, the insurance industry is alone among financial institutions in the United States in not having to disclose the rate of return on an insured's investment.<sup>105</sup> The need for such disclosure is particularly urgent since the returns on the insured's investment are very poor.<sup>106</sup>

In one remarkable case, the Supreme Court of New Jersey in *Bowler v. Fidelity Casualty Co. of New York*,<sup>107</sup> however, imposed a duty of disclosure on the insured. Bowler had a disability policy which entitled him to payment for 200 weeks. If the insured was still permanently disabled at the end of 200 weeks, the company was obliged to pay him benefits for another 600 weeks. At the end of 200 weeks, the insurer's doctor decided that Bowler was not totally disabled. This finding was written despite the fact that the insurer's doctor found that Bowler still had an ulcer on his right foreleg and walked with a cane and a limp. Further, the report noted that Bowler had "a very, very poor leg and foot".<sup>108</sup> Despite this bleak diagnosis, the report

<sup>103</sup> The first case to impose liability on an insurer in this kind of situation was *Duffy v. Banker's Life Ass'ce.*, 160 Iowa 19, 139 N.W. 1087 (1913). Some cases imposed liability on the basis of "acceptance by silence"; see, e.g., *American Life Insurance Co. of Alabama v. Hutcheson*, 109 F. 2d. 424 (6th Cir., 1940).

<sup>104</sup> See *Great Northern Life Insurance Co. v. Scott*, 181 Okla. 179, 72 P. 2d 790 (1937).

<sup>105</sup> See the Report of the Federal Trade Commission, *Life Insurance Price Disclosure*, Bureau of Consumer Protection, Bureau of Economics (Washington, D.C., 1979). The report stated, at p. 100, that the "insurance industry was the only savings medium that does not disclose the rate of return paid on consumer savings".

<sup>106</sup> Thus, for policies held for five years the return was minus 9 to minus 19%; for policies held for 10 years the return was minus 4% to plus 2%. Finally, for policies held for 20 years the return was between 2% and 4.5%; *ibid.*, at p. 4.

<sup>107</sup> 250 A.2d 580 (1969).

<sup>108</sup> *Ibid.*, at p. 586.

concluded that Bowler "is capable of doing many types of work and that he is not totally and completely disabled".<sup>109</sup>

Bowler took no legal action for many years and the six-year statute of limitations had passed. Eventually, Bowler found a lawyer who argued, successfully, that the insurer could not shield behind the statute of limitations because its treatment of the policyholder was "shocking and unconscionable".<sup>110</sup>

Mr. Justice Francis, writing for a unanimous court, held that the insurer was under a legal obligation to inform a layman that a particular phrase had been given a broad interpretation by the courts. The critical passage in the opinion is:<sup>111</sup>

In situations where a layman might give the controlling language of the policy a more restrictive interpretation than the insurer knows the courts have given it and as a result the uninformed insured might be inclined to be quiescent about the disregard or non-payment of his claim and not to press in timely fashion, the company cannot ignore its obligation. It cannot hide behind the insured's ignorance of the law; it cannot conceal its liability. In these circumstances it has the duty to speak and disclose, and to act in accordance with its contractual undertaking. The slightest evidence of deception or overreaching will bar reliance upon time limitations for prosecution of the claim.

The *Bowler* case seems to stand in splendid isolation, although some of the cases where there has been a "bad faith" denial of liability in first party contracts also seek to punish unconscionable behaviour by the insurer.<sup>112</sup>

### The Insurer's Duty of Good Faith in Defending Liability Claims

It has been shown that as early as 1906 in the *St. Louis Dressed Beef*<sup>113</sup> case the American courts recognized an insurer's duty to defend the insured in a liability policy. The issue that arose in *St. Louis Dressed Beef* has come before the American courts again and they have reshaped the law.

In *Communale v. Traders and General Insurance*,<sup>114</sup> Mr. and Mrs. Communale were struck by a truck driven by the insured. The insured was insured with Traders and General Insurance Co. with a maximum liability of \$10,000 per person and \$20,000 per accident. The insurers refused to defend the insured because they

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<sup>109</sup> *Ibid.*

<sup>110</sup> *Ibid.*, at p. 587.

<sup>111</sup> *Ibid.*, at p. 588.

<sup>112</sup> See cases cited, *infra*, at footnotes 126 to 132.

<sup>113</sup> See, *supra*, footnote 89.

<sup>114</sup> 328 P.2d 198 (1958).

(the insurers) maintained that the insured was driving a truck that did not belong to him. The insured hired competent counsel to represent him. At trial, Mr. Communale recovered \$25,000 and Mrs. Communale \$1,250. The insured now sought to recover this amount from the insurer and the California Supreme Court held that he was entitled to do so. In this case, the court used the language of good faith and fair dealing. In the court's words:<sup>115</sup>

There is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement.

The second innovation in the *Communale* case is that the court held that the insurer was liable for the excess amount, over the policy limits. This conclusion is impossible to justify logically but clearly the court wished to penalize insurers who breached their duty to defend liability claims.

The penal element came to the fore in the tragic case of *Crisci v. Security Insurance Co. of New Haven*.<sup>116</sup> In that case Mrs. Crisci (the insured) had taken out a liability policy for \$10,000 with the insurer, in respect of an apartment building owned by her. One of her tenants, June Di Mare was descending the apartment's wooden staircase when a tread gave way. She fell through the resulting opening up to her waist and was left hanging 15 feet above the ground. Mrs. Di Mare suffered serious physical injuries and developed a very severe psychosis.

Incredibly, the insurer refused to settle for \$9,000 and, at trial, the jury awarded \$101,000 to Mrs. Di Mare against the insured.

As a result of paying this judgment, the insured, a widow of 70, became indigent. She worked as a babysitter, and her grandchildren paid her rent. Her physical health declined, she suffered bouts of hysteria and she attempted suicide.

Eventually, the insured brought an action against her insurer. The Supreme Court of California, by a majority of 6-1, awarded the insured \$91,000 (plus interest) on the ground that since the insurer had acted in bad faith, it was liable for any part of the judgment that was in excess of the \$10,000 for which Mrs. Crisci had insured. The court also awarded Mrs. Crisci \$25,000 as compensation for pain and distress.

The insurer's duty to defend a liability claim was also accepted

<sup>115</sup> *Ibid.*, at p. 200.

<sup>116</sup> 426 P.2d 173 (1967).

by the Kentucky Court of Appeals in *Manchester Insurance and Indemnity Co. v. Grundy*,<sup>117</sup> which held that the insurer's duty rested in contract and tort.

The duty of the insurer to act in good faith was embraced by the Supreme Court of New Jersey in *Rova Farms Resort Inc. v. Investors Insurance Co. of North America*.<sup>118</sup> The insured operated a recreational resort including a lake used by commercial guest patrons for swimming. The insured carried liability insurance with a maximum of \$50,000. The policy required the insurer to defend any action brought against the insured.

Lawrence McLaughlin, a commercial invitee, dove from the diving platform into three or four feet of murky water and his head struck the unseen bottom of the lake. As a result of this accident McLaughlin suffered severe physical injuries.

The insurer made an incredibly low offer of \$12,500, which it adamantly refused to increase. Eventually, at trial, the jury awarded \$225,000 to McLaughlin. Rova managed by a variety of devices, including a mortgage on its property, to raise \$175,000. Rova sought to recover the \$175,000 from its insurer. The Supreme Court of New Jersey unanimously upheld Rova's contention.<sup>119</sup> Chief Justice Hughes stressed the fact that the insurer had never sought to increase its "first-day offer" of \$12,500. The Chief Justice stressed, at several points, that the insurer owed the insured a "fiduciary" duty.

There is no point in reviewing further authorities. There are two points to be made about these cases. Where an insurer has undertaken the duty to defend an action, all one need say is that the insurer is under a duty to act reasonably in performing its contract. The concept of "good faith" seems redundant here.

The real function of "good faith" seems to be to allow courts to make the insurer pay amounts in excess of the policy limits. This is logically indefensible. If one disregards logic, the question that arises is whether making insurers pay sums in excess of policy limits is a desirable policy for the courts to follow.

In the short term, some victims get more generous settlements

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<sup>117</sup> 531 S.W. 2d 493 (1975).

<sup>118</sup> 323 A. 2d 495 (1974).

<sup>119</sup> Chief Justice Hughes gave the court's opinion. Mountain and Clifford JJ. gave an opinion concurring in the result.



and insureds are relieved from crushing liabilities, but the underlying problem cannot be resolved by the courts. The problem is that Legislatures, with pressure from insurance companies, keep the liability limits low. It is monstrous that, in a country which awards the largest tort damages in the world, motorists are allowed (and in some cases required) to insure for as little as, say, \$20,000 per accident. The occasional suit obtaining a sum in excess of policy limits will not help deal with this problem.

For one thing, many accident victims will accept ludicrously low awards out of sheer necessity. It will be remembered that in the *Crisci* case, Mrs. Di Mare was prepared to accept \$9,000 for a claim that was adjudged to be worth \$101,000.<sup>120</sup>

Second, some insureds will not be able to pay the excess amount and they will have to declare bankruptcy. It is uncertain if the trustee in bankruptcy will bring an action against the insurer for the excess award. Third, only a minority of jurisdictions seem to have accepted the insurer's responsibility for paying sums in excess of the policy limit.<sup>121</sup>

What is needed are legislative changes which would make insurers insure for unlimited amounts as they do in the United Kingdom — at least in cases of motor vehicle injury. American insurers have the same access to re-insurance facilities as their English counterparts. The prospects for this kind of reform taking place in the United States seem bleak, particularly in these days of the "great insurance liability crisis".

### **Bad Faith Settlement of First Party Contracts<sup>122</sup>**

Writing in 1980, Professor Eric Holmes of the University of Georgia pointed out that the courts of at least 21 states have held that plaintiffs could recover damages in excess of policy limits

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<sup>120</sup> See text, *supra*, footnote 118.

<sup>121</sup> It is difficult to be precise about the number of jurisdictions that have accepted the rule but I have been able to find reported cases in 17 jurisdictions.

<sup>122</sup> The literature on this subject is voluminous; see, e.g., Holmes, "Is there Life After Gilmore's Death of Contract? — Inductions from a Study of Commercial Good Faith in First Party Insurance Contracts", 65 *Cor. L.Q.* 330 (1980); Note, "Good Faith and Fair Dealing in Insurance Contracts: Gruenberg v. Aetna Insurance Co.", 25 *Has. L.J.* 699 (1974); Note, "The Expectation of Peace of Mind: A Basis for Recovery of Damages for Mental Suffering Resulting from the Breach of First Party Insurance Contracts", 56 *So. Cal. L. Rev.* 1345 (1983); Note, "Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort", 73 *Cal. L. Rev.* 1291 (1985).

where the insurer acted in bad faith by failing to pay well-founded claims.<sup>123</sup> Further, Legislatures in 17 states enacted legislation giving courts power to award damages in excess of policy limits.<sup>124</sup>

According to Holmes, the courts will impose this kind of liability when the insurer's conduct has been "outrageous".<sup>125</sup> An insured can run foul of procedural pitfalls in his claim for bad faith settlement. This is well illustrated by the decision of the Supreme Court of California in *Reichert v. General Insurance Co. of America*,<sup>126</sup> one of the early cases on the subject. In this case, the insured had taken out a fire policy covering his motel with four insurers. A fire caused damage to the motel to the extent of \$424,000. Reichert argued that the insurers promised to pay the claim "fairly and with promptness and dispatch".<sup>127</sup> In the event, the insurers did not do so and the insured was forced to sell his motel and to declare bankruptcy. The insured sought \$1.5 million compensatory damages and \$5 million punitive damages.

By a majority of 4-3, the California Supreme Court held that the insured's claims for compensatory and punitive damages vested in Reichert's trustee in bankruptcy and Reichert could not maintain them. As the trustee in bankruptcy is less likely than the insured to bring a claim for punitive damages, this represents a windfall for the insurer.

This case must be contrasted with *Gruenberg v. Aetna Insurance Co.*<sup>128</sup> In this case, the insured had taken out a policy on his restaurant business for \$35,000. The insured's premises were destroyed by fire. The defendant insurer's adjuster, after inspecting the damage, told the arson investigator of the Los Angeles Fire Department that the plaintiff had excessive coverage under his fire insurance policy. This was untrue. A few months after this information had been passed on to the Los Angeles Fire Department, the plaintiff was charged for having committed arson and for having defrauded an insurer.

The insured was eventually discharged and he claimed damages in respect of the outrageous conduct and bad faith of the insurers. As a result, he claimed to have suffered severe economic harm and severe emotional upset.

<sup>123</sup> See Holmes, *ibid.*, at p. 353.

<sup>124</sup> *Ibid.*, at p. 354.

<sup>125</sup> *Ibid.*, at p. 358.

<sup>126</sup> 442 P.2d 377 (1968).

<sup>127</sup> *Ibid.*, at p. 378.

<sup>128</sup> 510 P. 2d 1032 (1973).

The Supreme Court of California held by a majority of 6-1 that the insured was entitled to recover damages for mental distress "whether or not these facts constitute 'extreme' or 'outrageous' conduct".<sup>129</sup> The Supreme Court sent the case back to the trial court for assessment of these damages.

Many of the cases of bad faith settlement involve disability or medical insurance.

One of the earliest cases to impose liability for bad faith settlement was *Fletcher v. Western National Life Insurance Co.*<sup>130</sup> In that case, the insured was entitled to monthly payments of \$150 in the event of total disability. Benefits were payable for up to 30 years.

The insured, who had only a grade four education, was seriously injured in January, 1965, while lifting a 361-pound bale of rubber. After an operation, the insured returned to work on June 8, 1965, but was fired by his employer three weeks later because he could not work. Meanwhile, the insured filed a claim for workers' compensation for his injuries. When it looked as though the insurer might have to pay benefits for 30 years, their claims' supervisor argued that the insured was ill rather than injured. Under the illness part of the policy, the insurer was liable for only two years. In fact, the insurer made payments for only two years and then stopped payment. The insurer also maintained that the insured suffered from congenital back injury — a contention for which there was no evidence. To add insult to injury, the insurer argued that the insured had made material misrepresentations by not giving information about his congenital back injury!

The insured eventually brought a claim for compensatory damages and for punitive damages. The California Court of Appeals for the Fourth District, by a majority of 3-1, awarded compensatory damages and punitive damages of \$164,000. The majority stressed the fact that the "defendant's conduct was premeditated, continuous and persistent".<sup>131</sup>

In *Silberg v. California Life Insurance Co.*,<sup>132</sup> the complaint related to a bad faith settlement of a medical policy. The insured

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<sup>129</sup> *Ibid.*, at p. 1042.

<sup>130</sup> 10 Cal. App. 3d 376 (1970).

<sup>131</sup> *Ibid.*, at p. 408.

<sup>132</sup> 521 P. 2d 1103 (1974).

had a medical policy with the insurer up to a limit of \$5,000. The insured suffered an accident as a result of which he suffered serious injury. The insured notified the insurer of the accident and filed a workers' compensation claim. The hospital policy contained an exclusion for losses caused by injuries for which compensation was payable under workers' compensation. The policy also stated in part in capital letters: "ALL BENEFITS PAYABLE IN FULL REGARDLESS OF ANY OTHER INSURANCE YOU MAY HAVE."

Meanwhile the insured's application for workers' compensation was denied because he was self-employed but he was allowed to appeal this decision.<sup>133</sup>

The insured was now being denied hospital coverage by his insurer and workers' compensation benefits. As a result of not receiving any benefits, the insured had to change residence five times because of his inability to pay the rent. His utilities were turned off several times for non-payment, his wheelchair was repossessed and he had difficulty in affording medication to avoid constant pain. Ultimately in 1969, the insured suffered two nervous breakdowns.

The Supreme Court of California, by a majority of 6-1, held that the insurer had been guilty of bad faith but it awarded only compensatory damages amounting to \$75,000. It refused to award exemplary damages because there was no intent to injure the insured. It is difficult to see why Mrs. Crisci, or Mr. Fletcher for that matter,<sup>134</sup> recovered damages for emotional distress,<sup>135</sup> while Mr. Silberg, whose distress seems to have been equally great, recovered nothing under this head.

The great uncertainty in the law must undermine considerably any deterrent value that a penalty for breach of the insurer's duty of good faith must have. Moreover, when punitive damages are awarded, the amounts tend to be small.<sup>136</sup> This means that most, if not all, insurers will be able to pass on the costs through higher premiums or lower benefits.

The only satisfactory way of dealing with outrageous conduct

<sup>133</sup> Eventually, the insured did, after a long delay, receive workers' compensation benefits.

<sup>134</sup> See text, *supra*, footnote 118.

<sup>135</sup> See text, *supra*, footnotes 132 and 133.

<sup>136</sup> See Note, "Liability Insurers and Third Party Claimants: The Limits of the Duty", 48 U. Chi. L. Rev. 125 (1981). *Ibid.*, at p. 133, note 30, the author writes: "Judgments awarded for bad faith are trivial compared to the premium pool." Although the author is dealing with liability claims, the same is true for first party claims.

by insurers is to use the administrative process. Thus, agents, adjusters and, finally, companies who are guilty of outrageous conduct should have their licences withdrawn. This is what we do with, for example, delinquent lawyers, doctors and car dealers. Delinquent insurers should be treated in the same way.

### **Conclusion**

The doctrine of "good faith" in English and Canadian insurance law has, in my view, been a disaster. It has made an unequal contest between insurer and insured even more unequal.

American insurers have tried to use "good faith" as a means of assisting the insured, but the abuses that American courts seek to curb can only be dealt with by legislative and administrative action. Of course, it is possible to argue that the bizarre results which have occurred in the field of insurance will not be replicated in other areas of contract law. But the burden of showing why this should not be so must rest with the proponents of the good faith doctrine.